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SIPDIS

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C O R R E C T E D C O P Y (ADDING SENSITIVE/SIPDIS CAPTIONS)

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SUBJECT: SIERRA LEONE FORECASTS INCREASED DIAMOND EXPORTS,
BUT THE YEAR BEGINS INAUSPICIOUSLY

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1.(U) Summary: Diamonds have produced most of Sierra Leone's foreign exchange in recent years, accounting for more than 70% of the country's total 2005 exports. Diamond exports achieved a record \$142 million in 2005, and Sierra Leone is forecasting an 8.5% increase in 2006 to \$154 million. Sierra Leone's stones have historically been alluvial diamonds from rivers, but in the past year and a half kimberlite diamonds from pit mining have become increasingly important as alluvial production has declined. The record 2005 value masked a 9.9% decline in alluvial exports because prices reached new highs and kimberlite production rose 48% with its first full year of production. 2006 has begun inauspiciously despite the optimistic forecast. Diamond exports in January and February totaled only \$16 million, a 15.65% decline despite a 9.33% increase in per carat revenue from the same period in 2005. The 78,000 carats exported thus far in 2006 is a 27.56% decline overall, but more significantly, alluvial diamond exports have declined 47.59% while kimberlite diamonds have increased 38.85% over the same period in 2005. While various reasons are given for the decline, smuggling may be rising despite the Kimberley Process and U.S.-assisted reforms. Even without smuggling, Sierra Leone's foreign exchange dependence on alluvial diamonds will shrink as kimberlite production continues to rise and as diversification in the minerals sector expands with resumption of rutile and bauxite exports this year. End Summary.

Diamond Production Trends

2.(U) At the March 7, 2006 meeting of the High Level Steering Committee on Diamonds in which the U.S. Embassy participated, Director John Karimu of the National Revenue Authority (NRA) announced that his agency has projected a 8.5% increase in diamond export value for 2006 to \$154,000,000 based on an average \$220 per carat value with a target of 700,000 carats for export. The Government of Sierra Leone (GoSL) earns 5% from the kimberlite production and collects a 3% export duty on alluvials that is divided among the Ministry of Mineral Resources, the independent valuator, and the Diamond Area Community Development Fund (DACDF), leaving little for general government operations.

3.(U) The year 2006 has started inauspiciously with total diamond exports in January/February of only 78,006 carats, 27.56% less than the same period last year. The decline is due entirely to a sharp drop of 47.59% in alluvial diamond exports to 55,932 carats despite a per carat price increase of 4.07% to \$199.32. Sierra Leone's salvation has been Koidu Holdings Ltd., the sole kimberlite mine, which increased production by 38.85% to 18,074 carats with a per carat price increase of 35.71% to \$224.43 for a total kimberlite export value of \$4,056,223, or 60.69% more than in the first two months of 2005. The kimberlite figures were helped by some exceptionally large stones, including an 83 carat diamond in February.

4.(U) The drop in alluvial exports continues a decline that began in 2005. Although Sierra Leone's diamond exports reached a record \$141,940,244 in 2005, including a 5.88% increase over 2004 in alluvials to \$119,429,528, the rise concealed a 9.9% decline in alluvial production to 552,044 carats that was cushioned by a 17.52% increase in per carat value to \$216.34. The first full year of kimberlite production at Koidu Holdings also contributed to the record value of 2005 diamond exports. The kimberlite output increased by 48% over 2004 to 116,665 carats at an average per carat of \$192.95 for a total of \$22,510,716, a 62% increase in total kimberlite export value in 2005.

Explaining the Alluvial Diamond Decline

5.(U) Experts cite various reasons for the significant decline in alluvial exports. An extended long rainy season in 2005 and unseasonable rains in December and early January kept river levels high, making alluvial digging unusually difficult. A leading exporter contends that traditionally mined areas are being overmined, reducing their yield. Numerous new foreign mining operators have entered the alluvial sector with mechanized equipment. Their investments have not yet produced large yields. Two U.S. investments in diamond cooperatives, a new concept related to USAID's Integrated Diamond Management project, in the Kono District

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have produced little revenue, perhaps because cooperative members may be unwilling to share their better finds with their partners. Given the history of Sierra Leone's diamond sector, smuggling, which everyone acknowledges but pleads ignorance of, may also be increasing. Because it is an illegal, clandestine activity, there are no reliable statistics on diamond smuggling, but best guesses continue to range from 25% to 50% of Sierra Leone's alluvial production with the lower end being more likely.

6.(SBU) Legal alluvial diamond exports have been increasingly concentrated in the hands of two indigenous Lebanese exporters, Hisham Mackie and Kassim Basma, who are related by marriage. Their two companies exported 94% of the total alluvial diamond in January and February, mainly to Belgium with far smaller shipments to Israel, Japan, Tanzania, Germany, Hungary, and the USA. Exports by legitimate exporters was somewhat disrupted in the second half of 2005 when the National Revenue Authority (NRA) tried to impose a retroactive income tax of 3% on their total turnover since 2002 in addition to the 3% export duty that they pay. Since diamond exporters operate on consignment using the capital of their purchasers, this unrealistic requirement resulted in a stalemate with many diamonds possibly having been held off the market. A truce was established in December when Mackie and Basma agreed to a 30% income tax on their companies' 2005 profits with no retroactive years. They placed respectively 100 million leones (US\$33,610) and 40 million leones (US\$13,459) in escrow with the NRA pending an audit of their accounts. Mackie and Basma argued that retroactive payments would be unfair because the NRA had not sought taxes before 2005 and many other exporters from earlier years had

disappeared, having been unable to pay the high export license fee and the penalties for not reaching minimum required export levels. The NRA, recognizing the current overdependency on Mackie and Basma for exports, agreed in return to give them provisional clearance required for renewal of their export licenses for 2006. An outcome of the NRA audit is pending and could lead to further disruptive disputes. Mackie and Basma probably do not engage in smuggling because they have too much to lose if caught. Mackie recently told the Ambassador that in his view, "the Kimberley Process is working well in Sierra Leone." However, this applies to legally exported diamonds, and there are still ample opportunities for smuggling by diggers and dealers because of the limited enforcement capabilities of the Ministry of Mineral Resources' Mine Monitoring Officers.

Developments in the Mineral Sector

7.(U) Significant changes are coming to alluvial mining. As already noted, mechanized operations are pushing many traditional pick-and-shovel diggers aside. The largest such mechanized (aka artisanal) operation by the Sierra Leone Diamond Corporation (SLDC) will bulldoze a long section of the Selwa River's banks in the Kono district beginning this year. Paramount chiefs, who had received licensing benefits from the Diamond Area Community Development Fund, and the alluvial license holders are being compensated by the SLDC to allow this large operation to proceed.

8.(SBU) The Cabinet of the Sierra Leone Government is likely to approve soon five proposals, including one from Finesse Diamonds Corporation of New York, to purchase, cut, polish, and brand Sierra Leonean diamonds locally. Experts believe that the diamond sector can only support one or two such companies, and not all may invest. Exporter Mackie has assured the Ambassador that he will make his diamonds available for local purchase by these companies provided that they pay fair international prices. Finesse in its proposal is seeking up to 40% of local production. Finesse Vice President Alex Twersky has told the Ambassador that he believes that by also offering fair prices directly to alluvial diamond diggers and dealers, his company will draw more diamonds into the legitimate market. Whether these developments will significantly affect alluvial diamond exports for 2006 is uncertain.

9.(U) One change that is certain is that diamond exports as a percentage of Sierra Leone's total exports will decline this year as rutile (titanium dioxide) and bauxite exports resume after several years of disruption caused by the long civil conflict. Rutile production is backed by OPIC and European Union loan guarantees. In the diamond sector, kimberlite production is expected to increase as Koidu Holdings' second

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pipe operates for a full year. Looking beyond 2006, more kimberlite mines are expected to open in Kono and Tongo Fields (Kenema District). A British company has recently taken an option on reopening the Marampa iron mine in Lunsar (Port Loko District), which closed in 1974 due to declining ore quality. New technology may make that mine economical again. Argyll, a Swiss/British company, is actively prospecting for bauxite in the Port Loko and Kambia Districts. An American company, Advanced Industrial Minerals of Brunswick, Georgia, is prepared to begin ilmenorutile (tantalum/niobium) mining near Bumbuna in Tokolili District once government approval is obtained. Since both tantalum and niobium are used in manufacturing extreme temperature resistant capacitors, their revenue potential is considerable.

COMMENT

10.(SBU) Looking at Sierra Leone's mineral sector broadly, diamonds will remain a major generator of foreign exchange, but their export share is sure to fall as other mineral production expands, as cash crop exports increase, and as the economy more broadly diversifies. This appears especially to be true for alluvial diamonds, which were the "blood diamonds" of Sierra Leone's recent past. Nevertheless, the possibility of increased alluvial diamond smuggling is of serious concern. The global effort to regulate the international diamond sector must keep up with global market changes, and the GoSL's tax and regulatory policy must strike a correct balance to maximize legal export flows. Although violent conflict does not appear to be in Sierra Leone's near-term future, attention to alluvial diamond mining remains important. Corruption, exploitation, and localized resentment brought on by increasing diamond sector activity controlled by foreigners could threaten Sierra Leone's peace. As Sierra Leone's recent war clearly showed, when conventional mining is disrupted by violence, alluvial diamond mining can continue to fuel conflict.

HULL